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Economy

RBI Annual Report

INDIA

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RBI annual report: focus on medium-term challenges. Most of the risks associated with macroeconomic fundamentals are either balanced or subsiding. The annual report focused on medium-term challenges that need to be tackled to ensure macroeconomic stability. The report highlighted some measures that can help curb high food prices, along with outlining the issues on (1) revenue-led fiscal adjustment, (2) strengthening infrastructure by improving contractual arrangements for the private sector, (3) removing obstacles and improving access to finance and (4) managing the NPA cycle to ensure a sound banking system.

RBI's balance sheet expansion driven by growth in foreign currency assets

RBI's balance sheet increased by ~10% in the year ending June 30, 2014. This was mainly due to expansion in the foreign currency assets, which increased by ~15% (in rupee terms). The balance sheet of the issue department (in charge of notes in circulation) increased ~12% while the balance sheet of the banking department increased ~7.5%. Exhibits 1-5 detail RBI's balance sheet along with explanation on some of the components.

Record transfer to government due to zero transfer to contingency reserves

RBI's total gross income fell 13.1% to ₹646.2 bn in 2013-14 (see Exhibit 6). Earnings from foreign sources decreased due to lower interest rates in the global market. Earnings from domestic sources decreased due to higher depreciation (as yields were higher in 2013-14 compared to last year) even as profit on sale of securities was higher (see Exhibit 7). With expenditure falling 4.9%, RBI generated surplus of ₹526.8 bn with zero transfer to both contingency reserve (CR) and asset development reserve (ADR). The Technical Committee II (chaired by YH Malegam) recommended that since balances in CR and ADR are in excess of the required buffers, no further transfer was needed. Hence, the entire surplus of ₹526.8 bn was transferred to the central government, the largest-ever surplus transfer by RBI.

A few measures to reduce food inflation through supply-side management

RBI highlighted a few measures that could help reduce high food prices:

- **Agriculture price policy.** Given that long-term elasticity of market prices to MSP is close to unity, the model of fixing MSP (which is based on cost-plus approach) should be relooked at.
- **Equating wage growth to productivity growth.** Wage cost increase has been a major factor behind higher agriculture production costs. Wage increases in excess of productivity growth lead to a wage-price spiral and make food inflation a self-perpetuating cycle. Wage increases should be in line with labor productivity for rural employment programs to be non-inflationary.
- **Storage, warehousing and more competitive markets.** Short-term supply disturbances (such as weather-related ones) could lead to significant volatility, which can be reduced through increasing storage and warehousing facilities, as also cold storage facilities for perishable food, besides more competitive marketing structures. The Union Budget highlighted the need for a national market to introduce competition and integration across markets. State governments need to be encouraged to develop farmers' markets in towns, which would require suitable modifications of APMC Acts.
- **Effective use of international trade.** The export window should be shut only in extremis so as to give farmers gains from international trade and a fair chance of higher realization in an open economy. Imports should also be used liberally in anticipation of scarcity, and should not be delayed until scarcity (when it is too late to import). This will also improve consumer welfare.

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Some of the other key medium-term challenges

Fiscal adjustment through revenue augmentation

- To improve tax collection, it is important to improve tax efficiency and tax buoyancy. Tax efficiency can be improved through minimization of distortions by broadening the tax base, targeting negative externalities and strengthening tax compliance.

- Low returns on government investments in public sector undertakings, insufficient returns on use of natural resources and inadequate disinvestment receipts also contribute to low revenue mobilization. These should be addressed to put India's public finances on a firm footing.

- Engagement of professional merchant bankers with proven track records and measurable performance yardsticks with market-related fees and incentives is needed to ensure quicker decisions and professional management of disinvestments. These merchant bankers could quickly handle the process of road shows and putting together the prospectus so as to complete the entire process of budgeted disinvestment as quickly as possible.

- The government also needs to give a thought to privatizing some PSEs, which are not yielding due returns. This is typically the case where the PSEs suffer from capital misallocations and corporate governance issues.

Strengthening infrastructure by improving contractual arrangements for private sector

- The nature of contracts with the government determines the risk allocation to the private sector in infrastructure. The broad principle is to allocate such risks as can be controlled or managed by the private sector to them, but many current contracts do not fully reflect this principle.

- Based on learning from existing projects, revamped contract arrangements that limit risk transfer to project costs and controllable revenue items and use of innovations like Least Present Value of Revenue (LPVR) bids, e.g. for electronically tolled roads, may be examined.

- Revamped infrastructure contracts also need to factor in the possibility of renegotiation and include mechanisms that clearly lay out the process to be followed in such an event. This will reduce the advantages of those who bid unreasonably in the expectation of being able to renegotiate better terms subsequently. Also, a more level-playing field will help to attract foreign direct investment (FDI) into the sector.

Removing obstacles and improving access to finance

- A number of studies have shown that financing is a greater obstacle for small and medium enterprises (SMEs) than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the SME sector more than that of large companies.

- In the Indian case, there is overdependence of SMEs on trade credit. Lowering information asymmetry through improved credit reporting, and greater competition and productivity enhancements in banks to lower intermediation costs, are necessary to improve credit flow to SMEs.

- Harness technology to lower transaction costs and thus facilitating inclusion. Competition will also help, not just through more bank licensing but also by encouraging NBFCs and other businesses with the necessary capabilities and reach.

Managing the NPA cycle to ensure a sound banking system

- There is need for countercyclical capital buffers and dynamic provisioning to deal with cyclical economic movements.
- There is need to focus more closely on restructuring of standard loans.
- While encouraging the process of recovery of distressed assets through asset reconstruction firms (ARCs), RBI is taking steps to ensure that distressed asset sales to ARCs genuinely transfer risks from the banks.

Exhibit 1: RBI's balance sheet increased by ~10%

RBI's balance sheet, June year-ends, 2012-13 and 2013-14 (Rs bn)

Issue department					
Liabilities			**Assets**		
	2012-13	**2013-14**		**2012-13**	**2013-14**
Notes held in the banking department	**0.1**	**0.1**	**Gold Coin and Bullion:**		
Notes in Circulation	**12,016**	**13,445**	Held in India	674	650
Total Notes Issued	**12,016**	**13,445**	Held outside India	—	—
			Foreign Securities	**11,329**	**12,783**
			Total	12,003	13,343
			Rupee Coin	**2**	**2**
			Government of India Rupee Securities	**10**	**10**
Total Liabilities	**12,016**	**13,445**	**Total Assets**	**12,016**	**13,445**
Banking department					
Liabilities			**Assets**		
	2012-13	**2013-14**		**2012-13**	**2013-14**
Capital paid-up	**0.1**	**0.1**	**Notes**	**0.1**	**0.1**
Reserve Fund	**65**	**65**	**Rupee Coin**	**—**	**—**
National Industrial Credit	**0.2**	**0.2**	**Small Coin**	**—**	**—**
National Housing Credit	**2**	**2**	**Balances Held Abroad**	**3,395**	**3,727**
Deposits			**Investments (refer to Exhibit 4 for details)**	**7,276**	**7,767**
Government			**Loans and Advances to :**		
Central Government	1	1	Central Government	147	—
State Governments	0.4	0.4	State Governments	21	7
Banks			**Loans and Advances to:**		
Scheduled Commercial Banks	3,391	3,469	Scheduled Commercial Banks	187	294
Scheduled State Co-operative Banks	32	37	Scheduled State Co-operative Banks	—	—
Other Scheduled Co-operative Banks	55	63	Other Scheduled Co-operative Banks	2	1
Non-Scheduled State Co-operative Banks	2	5	Non-Scheduled State Co-operative Banks	—	—
Other Banks	91	103	NABARD	—	—
Others (refer to Exhibit 2 for details)	166	214	Others	8	69
Bills Payable	**1.9**	**0.4**			
Other Liabilities (refer to Exhibit 3 for details)	**8,083**	**8,838**	**Other Assets (refer to Exhibit 5 for details)**	**855**	**933**
Total Liabilities	**11,891**	**12,798**	**Total Assets**	**11,891**	**12,798**

Notes:

(a) Some items have been omitted to maintain brevity without any loss of information.

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 2: Retirement benefits form the largest portion in 'other deposits'
Details of 'other deposits' in RBI balance sheet, June year-ends, 2012-13 and 2013-14 (Rs bn)

	As on June 30	
	2013	**2014**
I. Rupee Deposits from the Foreign Central Banks and the Foreign Financial Institutions	15	12
II. Deposits from the Indian Financial Institutions	0.7	2.5
III. Deposits placed by Mutual Funds	0.0	0.0
IV. Accumulated Retirement Benefits (i+ii)	141	162
(i) Provident Fund	36	39
(ii) Gratuity and Superannuation Fund	105	123
V. Depositor Education and Awareness (DEA) Fund	—	28
VI. Miscellaneous	9	10
Total	**166**	**214**

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 3: Zero transfer to contingency reserve and asset development reserve
Details of 'other liabilities' in RBI balance sheet, June year-ends, 2012-13 and 2013-14 (Rs bn)

	As on June 30	
	2013	**2014**
a. Contingency Reserve		
Balance at the beginning of the year	1,954	2,217
Add: Accretion during the year	262	—
Balance at the end of the year	2,217	2,217
b. Asset Development Reserve		
Balance at the beginning of the year	182	208
Add: Accretion during the year	25	—
Balance at the end of the year	208	208
c. Currency and Gold Revaluation Account		
Balance at the beginning of the year	4,732	5,201
Add: Net Accretion (+)/Net Depletion (-) during the year	(+) 469.41	(+) 520.50
Balance at the end of the year	5,201	5,722
d. Investment Revaluation Account		
Balance at the beginning of the year	122	25
Add: Net Accretion (+)/Net Utilisation (-)during the year	(-) 97.37	(+) 13.06
Balance at the end of the year	25	38
e. Foreign Exchange Forward Contracts Valuation Account		
(Previously known as Exchange Equalisation Account)		
Balance at the beginning of the year	24	17
*Transfer from Exchange Account/** MTM gain on forward contracts	16.99*	42.98**
Add: Net Accretion (+)/Net Utilisation (-) during the year	(-) 24.05	(-) 16.99
Balance at the end of the year	17	43
f. Provision for Payables	**18**	**17**
g. Surplus Transferable to the Government of India	**330**	**527**
h. Miscellaneous	**67**	**68**
i. Total (a to h)	**8,083**	**8,838**

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 4: Foreign securities holdings have doubled in 2013-14
Details of 'investments' in RBI balance sheet, June year-ends, 2012-13 and 2013-14 (Rs bn)

Investments	2012-13	2013-14
a) Government of India Rupee securities	6,739	6,685
b) Foreign securities	521	1,067
c) Shares in BIS/SWIFT	3	3
d) Holdings in Subsidiaries/Associate institutions	13	13
Total	**7,276**	**7,767**

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 5: Gold forms bulk of 'other assets'
Details of 'other assets' in RBI balance sheet, June year-ends, 2012-13 and 2013-14 (Rs bn)

	As on June 30	
	2013	2014
Fixed Assets (net of accumulated depreciation)	5	1
Gold	613	590
Accrued income (a + b)	224	222
a. on loans to employees	3	1
b. on other items	221	222
Swap Amortization Account	—	59
Revaluation of Forward Contracts accounts	—	43
Miscellaneous	14	17
Total	**855**	**933**

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 6: RBI income fell 13% in 2013-14
Trends in gross income, expenditure and net income, June year-ends, 2008-14 (Rs bn)

	2008	2009	2010	2011	2012	2013	2014
1. Foreign Sources:							
Interest , Discount, Exchange	518.8	508.0	251.0	211.5	198.1	207.5	197.7
2. Domestic Sources	58.7	99.4	77.8	159.2	333.7	536.1	448.5
Interest	49.6	90.6	66.5	150.3	323.4	523.1	435.4
Other earnings	9.1	8.8	11.4	8.9	10.3	13.1	13.1
3. Total Income (Gross) (1+2)	**577.5**	**607.3**	**328.8**	**370.7**	**531.8**	**743.6**	**646.2**
Less transfer to:							
Contingency reserve	334.3	261.9	51.7	121.7	246.8	262.5	0.0
Asset development reserve	32.1	13.1	5.5	12.3	23.5	25.5	0.0
4. Total transfers	366.4	275.0	57.2	134.0	270.3	287.9	0.0
Total Income (Net) (3-4)	**211.1**	**332.3**	**271.7**	**236.7**	**261.5**	**455.6**	**646.2**
5. Total Expenditure	**61.0**	**82.2**	**84.0**	**86.6**	**101.4**	**125.5**	**119.3**
Net disposable income	150.2	250.1	187.6	150.1	160.1	330.1	526.8
Transfer of surplus to government	**150.1**	**250.1**	**187.6**	**150.1**	**160.1**	**330.1**	**526.8**

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 7: Earnings from domestic sources fell due to depreciation
Details of earnings from domestic sources, June year-ends, 2013-14 (Rs bn)

	As on June 30		Variation	
	2013	**2014**	**Absolute**	**Per cent**
Domestic Assets	8,659	8,664	5	0
Weekly Average of Domestic Assets	**7,725**	**8,695**	**970**	**13**
Earnings (I + II+III)	**536**	**448**	**(88)**	**(16)**
I. Interest and other Securities Related Income				
i) Profit on Sale of Securities	85	331	246	288
ii) Net Interest on LAF operations	65	59	(6)	(9)
iii) Interest on MSF operations	0	17	17	15,764
iv) Interest on holding of Domestic Securities	409	471	62	15
v) Depreciation	55	480	425	768
Total (i+ii+iii+iv-v)	**504**	**398**	**(106)**	**(21)**
II. Interest on Loans and Advances				
i) To Government (Central & States)	1	4	3	209
ii) To Banks & Financial Institutions	18	33	15	88
iii) To Employees	0.5	0.5	0.0	0.0
Total (i+ii+iii)	**19**	**37**	**18**	**93**
III. Other Earnings				
i) Discount	0.3	0.0	(0.3)	(96)
ii) Exchange	0.0	0.0	0.0	0.0
iii) Commission	11	13	1	13
iv) Rent realised, Profit or Loss on sale of Bank's property an	2	1	(1)	(68)
Total (i+ii+iii+iv)	**13.0**	**13.1**	**0.1**	**0.5**

Source: RBI Annual Report FY2014, Kotak Economic Research

Exhibit 8: Caution on external sector vulnerabilities should continue
Various metrics of external sector vulnerability (%)

	Mar-2011	Mar-2012	Mar-2013	Mar-2014
Ratio of External Debt to GDP	18.2	20.5	22.0	23.3
Ratio of Short-term to Total Debt (originial maturity)	20.4	21.7	23.6	20.3
Ratio of Short-term to Total Debt (residual maturity)	40.6	40.9	42.1	39.6
Ratio of Concessional Debt to Total	14.9	13.3	11.1	10.5
Ratio of Reserves to Total Debt	95.9	81.6	71.3	69.0
Ratio of Short-term Debt to Reserves	21.3	26.6	33.1	29.3
Ratio of Short-term Debt (Residual Maturity) to Reserves	42.3	50.1	59.0	57.4
Reserves Cover of Imports (in months)	9.5	7.1	7.0	7.8
Debt Service Ratio (Debt Service Payments to Current Receipts)	4.4	6.0	5.9	5.9
Net International Investment Position (NIIP, US$ bn)	(207.0)	(264.7)	(326.7)	(331.6)
NIIP/GDP ratio	(11.9)	(14.8)	(17.6)	(17.6)

Source: RBI Annual Report FY2014, Kotak Economic Research

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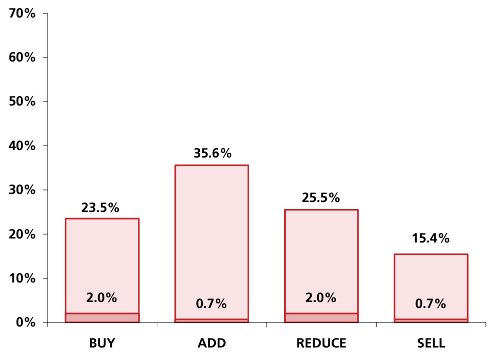

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Source: Kotak Institutional Equities

As of June 30, 2014

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